Review of the Financial Plan of the City of New York

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- **Revenue collections continue to surge and are now projected to exceed the estimates in the July 2005 Plan by $3.2 billion in FY 2006.**
- **Most of the additional revenues are due to continued strength in real estate transactions, record Wall Street bonuses, and higher capital gains realizations.**
- **The economy continues to grow at a moderate rate, but it faces major risks from weaker consumer spending, a softening real estate market, higher interest rates and energy costs, and large federal budget and trade deficits.**
- **Recent labor agreements are expiring and the City will have to negotiate new agreements covering fiscal years 2007 through 2010.**
- **The City intends to defer $1.5 billion in pension contributions that were planned for fiscal years 2006 and 2007.**
- **State actions to ease the Medicaid burden on localities are expected to save New York City more than $5 billion through 2010.**
- **Despite these actions, Medicaid, debt service, pensions, and health insurance are expected to consume about half of City fund revenues in 2008, compared with 37 percent in 2003.**
- **The debt service burden is projected to rise from 11.2 percent of City fund revenues in FY 2006 to 15.1 percent by FY 2009—the highest level in 15 years.**
- **The Governor's proposed budget does not address the Campaign for Fiscal Equity lawsuit, which requires the State to ensure that the City has the resources necessary to provide a sound, basic education.**
- **The Health and Hospitals Corporation, the Off-Track Betting Corporation, and the New York City Housing Authority all face significant long-term fiscal challenges.**

Three years ago, New York City projected a $6.7 billion budget gap for FY 2005. Through a combination of federal, State, and City actions, and an unexpected surge in tax revenues, the City ended FY 2005 with a record surplus of $3.5 billion. This reversal of fortune came less than four years after the terrorist attack on the World Trade Center.

New York City now projects a surplus of $3.3 billion for FY 2006 and a balanced budget for FY 2007. This year's surplus would have been even higher—$4.5 billion—if not for certain actions proposed by the Mayor. Moreover, the surplus is likely to grow by nearly $500 million as the year progresses and, although the City still faces budget risks, the FY 2008 budget gap is manageable.

The Mayor has proposed actions that would provide future benefits, such as the creation of a health insurance trust fund for the benefit of current and future retirees that would be initially funded with $2 billion over two years from the general fund. The City believes it could also draw upon the trust in times of need—effectively using it as a rainy-day fund.

The Mayor also proposes to defer $454 million in tobacco revenues to FY 2008, when it would be needed, and to hold the line on new spending initiatives. In addition, the Mayor would set aside $200 million annually to help fund the capital program on a pay-as-you-go basis.

New York City is reaping the benefits from the current economic recovery and conservative revenue forecasts. While the City continues to rely on the surplus to balance the budget, the Mayor has proposed setting aside resources to cover future liabilities. This prudent approach is commendable, especially given the risks to the economy and the potential risks posed by future federal and State budgets.

Table 1
OSDC Risk Assessment of NYC Financial Plan
(in millions)

	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
			Better/(Worse)		
Gaps Per February 2006 Plan	**$ - - -**	**$ - - -**	**$ (3,447)**	**$ (3,500)**	**$ (2,711)**
Tax Revenues	400	600	500	400	400
Debt Service Savings	51	51	- - -	- - -	- - -
Hiring Delays	50	- - -	- - -	- - -	- - -
Anticipated State and Federal Aid	- - -	(250)	(150)	(150)	(150)
Anticipated State Education Aid	- - -	(100)	(100)	(100)	(100)
Uniformed Agency Overtime	(15)	(50)	(40)	(40)	(40)
OSDC Risk Assessment	**$ 486**	**$ 251**	**$ 210**	**$ 110**	**$ 110**
FY 2006 Surplus Transfer	(486)	486	- - -	- - -	- - -
FY 2007 Surplus Transfer	- - -	(737)	737	- - -	- - -
Surplus/(Gaps) to be Closed*	**$ - - -**	**$ - - -**	**$ (2,500)**	**$ (3,390)**	**$ (2,601)**
Additional Risks and Offsets:					
Campaign for Fiscal Equity Settlement		(560)	(1,100)	(1,600)	(2,200)
Wage Increase at Projected Inflation Rate		(100)	(350)	(650)	(950)

* The February Plan includes a general reserve of $100 million in FY 2006 and $300 million annually thereafter. In addition, the Mayor has proposed making an irrevocable $2 billion contribution to a retiree health insurance trust fund, which the City believes it could draw upon in times of need by foregoing its planned annual contribution to the trust.

Economic Overview

New York City's continued economic recovery has helped fuel revenue growth through high corporate and business profitability, large capital gains realizations, modest employment growth, and sustained high real estate market values and transaction activity. In addition, Wall Street had a great year in 2005, as strong merger and acquisition activity yielded near-record revenues and record year-end bonuses.

The February 2006 Plan assumes that economic growth will slow slightly over the next few years. Nonetheless, the economy is still expected to expand at a modest pace—a recession is not anticipated—with the slowest growth in calendar year 2007, followed by a gradual strengthening. Jobs and incomes are forecast to continue rising throughout the financial plan period, while national corporate profitability is forecast to decline only in 2007.

While the economic outlook is generally favorable, a number of factors still pose serious risks to the City's economic forecast. The greatest risk is a more significant slowdown in consumer spending, which accounts for two thirds of economic activity. The Federal Reserve has been slowly pushing up interest rates, and while mortgage rates have risen only slightly and still remain relatively low by historical standards, consumers' ability to refinance their home mortgages and tap into rising equity is waning. Moreover, further equity gains are being limited as the residential real estate market has begun to soften. Consumer spending is also being squeezed by higher interest rates for other loans and by increased energy prices. Under these pressures, the savings rate has turned negative.

Another troubling development is that the yield curve has flattened and begun to invert—historically a sign of slow growth or a recession. This has occurred because the rise in short-term interest rates has not been accompanied by a similar increase in long-term interest rates.

In addition, the Federal Reserve could raise rates beyond the financial market's current expectations. The surge in business spending may again be short-lived. Meanwhile, federal budget and trade deficits continue to widen.

Fiscal Year 2006

The City projects a surplus of $3.3 billion for FY 2006, which rivals last year's record surplus of $3.5 billion. This year's surplus would have been significantly higher—reaching $4.5 billion—if not

Table 2
Financial Plan Reconciliation
July 2005 Plan vs. February 2006 Plan
(in millions)

	FY 2006	FY 2007	FY 2008	FY 2009
	Better/(Worse)			
Surplus/(Gaps) Per July 2005 Plan	**- - -**	**$ (4,507)**	**$ (4,470)**	**$ (3,925)**
Revenues				
Personal Income Tax	$ 992	$ 1,100	$ 932	$ 1,012
Real Estate Transaction Taxes	972	406	348	317
Business Taxes	503	417	344	366
All Other Taxes	440	70	21	102
Subtotal	**2,907**	**1,993**	**1,645**	**1,797**
Agency Gap-Closing Program	96	90	68	68
Non-Tax Revenues	163	181	(8)	(9)
Anticipated State and Federal Aid	- - -	350	250	250
Extension of Property Tax Rebate	- - -	- - -	(256)	(256)
Total	**3,166**	**2,614**	**1,699**	**1,850**
Expenditures				
Collective Bargaining	(696)	(1,381)	(1,515)	(1,514)
Energy Costs	(97)	(102)	(88)	(83)
Education	(43)	(56)	(57)	(57)
Changes in Pension Assumptions and Methods	925	571	(161)	(452)
Medicaid	561	223	223	223
Agency Gap-Closing Program	132	172	143	143
General Reserve	200	- - -	- - -	- - -
Prior Year's Expenses	400	- - -	- - -	- - -
Debt Service	41	117	33	9
State Education Aid	35	300	337	337
Other Agency Expenses	(139)	(83)	(45)	(53)
Total	**1,319**	**(239)**	**(1,130)**	**(1,447)**
Net Change During FY 2006	**4,485**	**2,375**	**569**	**403**
Discretionary Transfers				
Surplus Transfer	(3,253)	3,253	- - -	- - -
Retiree Health Benefits Trust Fund	(1,000)	(1,000)	- - -	- - -
TSASC	(232)	(121)	454	22
Surplus/(Gaps) Per February 2006 Plan	**$ - - -**	**$ - - -**	**$ (3,447)**	**$ (3,500)**

Sources: NYC Office of Management and Budget; OSDC Analysis

for discretionary actions proposed by the Mayor that will reduce the size of the surplus.

The July Plan projected budget gaps of about $4.5 billion for each of fiscal years 2007 and 2008, but developments since then have allowed the City to balance the FY 2007 budget and reduce the FY 2008 budget gap to $3.5 billion.

As shown in Table 2, the FY 2006 surplus largely results from higher-than-expected collections from personal income ($992 million) and real estate transaction taxes ($972 million); changes in pension methodologies and assumptions that slowed the growth in pension contributions ($925 million); and actions taken by New York State to limit the growth in the local share of Medicaid ($561 million).

Revenues

Revenue collections continue to exceed all reasonable expectations and are now projected to exceed the estimates in the July Plan by $3.2 billion in FY 2006, $2.6 billion in FY 2007, and by about $1.8 billion in each of fiscal years 2008 and 2009.[1] The increase in anticipated revenue, outlined below, is not limited to a single area.

[1] These estimates exclude the proposed transfer of $454 million in anticipated tobacco revenue from fiscal years 2006 and 2007 to FY 2008, when it will be needed.

- Personal income tax collections are now forecast to be higher by about $1 billion annually, reflecting a higher base in FY 2006 due to strong wage growth (notably from Wall Street) and strong capital gains realizations.
- Real estate transaction taxes are forecast to exceed expectations by $972 million in the current year, boosted by commercial transactions, and by about $350 million annually through FY 2010.
- Business taxes are expected to be higher by $503 million in FY 2006, with about $375 million expected to recur annually through FY 2009.
- The February Plan assumes that the State and federal governments will provide an additional $350 million in aid during FY 2007 and $250 million annually thereafter. These estimates may prove optimistic, however, in light of proposed federal and State budgets.

Expenditures

City-funded expenditures are projected to be $1.3 billion less than projected in July 2005,[2] largely because of lower-than-planned pension contributions associated with changes recently approved by the pension boards ($925 million); savings associated with State Medicaid cost-containment actions ($561 million); anticipated savings from prior years' expenses ($400 million); and a drawdown in the general reserve ($200 million). As discussed below, a number of other significant developments occurred during the course of the fiscal year.

- Collective bargaining costs are expected to be higher than projected in July by $696 million in FY 2006 and by more than $1.4 billion in subsequent years based on recently negotiated or anticipated agreements. The February Plan assumes the receipt of $300 million in additional State education aid beginning in FY 2007 to help fund the new labor agreement with the City's teachers.
- Energy costs are now projected to be higher than the July 2005 forecast by about $93 million annually, largely because of increased international demand for oil.
- Agency actions are expected to generate resources of $228 million in FY 2006 and similar amounts in subsequent years. About half would come from revenue initiatives, such as increased fees; the other half would come from savings, mostly from shifting costs to the federal and State governments, reestimates, and reductions in subsidies to libraries and cultural institutions.

Discretionary Transfers

The City intends to create a health insurance trust fund for the benefit of current and future retirees, and to transfer $1 billion from the general fund to the trust in each of fiscal years 2006 and 2007. If not for this transfer and a delay in recognizing certain TSASC revenues, the surplus projected for FY 2006 would have totaled $4.5 billion.

The Governmental Accounting Standards Board (GASB) has issued rules that will require New York City and other governmental entities to calculate and report their obligations to current and future retirees for benefits other than pensions. Although the accounting rules do not require governmental entities to fund these liabilities, credit rating agencies, when determining their ratings, will undoubtedly consider the size of these liabilities and how they are addressed.

Preliminary estimates put the value of the City's liability in excess of $50 billion, which could require an annual contribution of about $4 billion if funded on an actuarial basis. The City currently funds these liabilities on a "pay-as-you-go" basis, which is expected to grow from $1 billion in FY 2006 to $1.5 billion by FY 2010.

Although the details of the trust fund have yet to be worked out, the City intends to contribute $1 billion to the trust this year and another $1 billion next year. In addition, the City would transfer to the trust an amount equal to the projected cost on a pay-as-you-go basis. The initial $2 billion contribution would be invested and the principal and interest would be dedicated to retiree health benefits.

[2] This estimate excludes the planned transfer of $1 billion from the general fund to the proposed retiree health insurance trust. Including this transfer, planned spending for FY 2006 would now be about $300 million less than planned in July 2005.

City officials believe the City will be able to draw upon these resources in the future by foregoing the pay-as-you-go contribution to the trust, which will free up resources for other needs. In effect, the trust fund would also act as a rainy-day fund in the event of unforeseen contingencies, such as a downturn in the economy.

The City also plans to delay the recognition of $454 million in TSASC revenues[3] from fiscal years 2006 and 2007 until FY 2008, when those resources will be needed. In addition, the Mayor has proposed setting aside $200 million annually to fund capital projects on a pay-as-you-go basis, which would produce $144 million in savings through FY 2010.

Annual Operating Results

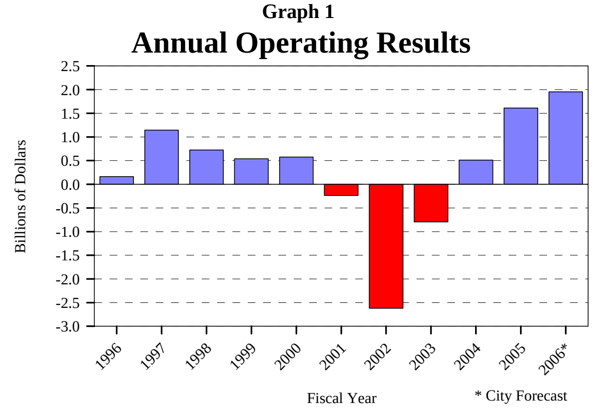
Three years ago, New York City projected a $6.7 billion budget gap for FY 2005. Through a combination of federal, State, and City actions, and an unexpected surge in tax revenues, the City ended FY 2005 with a record surplus of $3.5 billion. This reversal of fortune came less than four years after the terrorist attack on the World Trade Center. The FY 2006 surplus, excluding proposed discretionary transfers, now totals $4.5 billion and could reach $5 billion by the end of the fiscal year.

The City intends to use most of the surplus to help balance the FY 2007 budget, continuing a practice it has followed in past years. The transfer of resources between years, however, masks the relationship between recurring revenues and expenditures. We believe a more accurate picture of the City's fiscal condition would be obtained by examining the results of current-year operations—the difference between revenues and expenditures incurred in the current year.

As shown in Graph 1, the City spent more than it took in during fiscal years 2001 through 2003 as it faced the budgetary impact of the recession and the attack on the World Trade Center. The deficit was masked in those years, both by the City's practice of transferring the prior year's surplus to the following year and by using the proceeds from Transitional Finance Authority Recovery Bonds (i.e., deficit financing), which were authorized by New York State after September 11, 2001.

In each of the past three years, the current-year operating surplus has grown, and the City is now on track to reach a new record in FY 2006—almost $2 billion.[4] The practice of balancing the budget one year at a time, however, works only as long as the surplus lasts.

Graph 1



Sources:NYC Comptroller; NYC Office of Management and Budget; OSDC Analysis

Impact of the State Budget

Excluding education aid, the February Plan assumes that the budget adopted by New York State will include actions that will produce $250 million in assistance beginning in FY 2007. The State Division of the Budget (DOB) estimates that the Governor's proposed budget will provide $111 million in assistance. The City places the value at about $70 million, excluding $28 million in public assistance savings from actions that it believes are unlikely to be approved by the State Legislature. We estimate that the potential shortfall in anticipated State aid totals about $150 million at this point in the financial planning process.

The Governor's proposed budget does not address the Campaign for Fiscal Equity (CFE) lawsuit. Although the lawsuit is under appeal by the Governor, the courts have ruled that the State's school funding system is unconstitutional, and have ordered the State to ensure that New York

[3] These funds result from the master settlement agreement between attorneys general from 46 states and major tobacco manufacturers.

[4] This estimate excludes the planned transfer to the proposed retiree health insurance trust fund and is different from the surplus reported by the City in its financial plan. That surplus includes resources from prior years.

City has the resources necessary to provide a sound, basic education. The Governor's proposed budget also would not provide the capital resources contemplated under the CFE ruling. In response the Mayor has announced that the planned expansion of 53,000 seats in schools, and other renovations, may be indefinitely delayed.

The February Plan anticipates a $300 million increase in State education aid to help fund the contract with the United Federation of Teachers (UFT), but the Governor's budget provides an increase of only $104 million. Of that amount, $40 million would be dedicated to fund debt service on bonds that were issued by the Municipal Bond Bank to meet the State's obligation for prior-year education aid, leaving only $64 million to help fund the UFT agreement.

The Governor's budget includes an additional $375 million for Sound Basic Education Aid, which is intended to increase resources and improve the performance of high-need school districts. Although the amounts that will be allocated to individual school districts have not yet been determined, the City is likely to receive a substantial portion. Thus, we believe that the City could realize at least $200 million in additional education aid, or $100 million less than anticipated in the February Plan.

The Governor also has proposed allocating $530 million to fund a program called STAR-Plus, which would provide tax rebates to residents in school districts that limit growth in spending—but New York City would be ineligible to participate.

Proposed Medicaid cost-containment initiatives would save New York State $1.3 billion, but would not have any direct impact on the City's budget because last year the State imposed a cap in the growth in the local share of Medicaid. The Governor's proposals could, however, reduce the number of persons eligible for public health insurance, and could increase costs for health care providers. The DOB estimates that the Governor's proposals would increase costs at the Health and Hospitals Corporation by $72 million; the City estimates the impact at about $150 million. In either case, the potential impact could put pressure on the City to increase its subsidy to HHC.

City budget officials estimate that the Governor's budget proposals will reduce federal welfare funds to the City by $185 million annually beginning in FY 2007. Last year, the State enacted similar changes in welfare funding formulas that reduced the City's welfare revenues by $175 million, but the City offset the impact with other federal and State categorical resources. The City may not have the same flexibility next year.

Finally, a proposed increase in combined State and City taxes on cigarettes will raise the per-pack cost by $0.50, to $3.50, with the net increase flowing to the City. While the City could realize an additional $36 million from this source, it estimates that revenues could be reduced by $18 million if the higher price significantly reduced sales and the City were required to compensate the State for any revenue loss.

Federal Budget

The February Plan assumes that the federal government will take actions to provide New York City with $100 million in FY 2007. The federal government, however, has taken actions that will reduce funding to a number of programs, and the State and the City could come under pressure to compensate for such reductions.

Under the Deficit Reduction Act of 2005, the largest reductions will occur over five years in education ($12 billion, mostly in student loan and grant programs), Medicare ($6 billion, primarily in cuts to health care providers and managed care plans), and Medicaid ($5 billion in cuts to health care providers and beneficiaries). The President's budget proposal also reduces or does not increase grants that comprise a large portion of the City's annual federal aid, such as Title I education aid, special education grants, community development block grants, and federal funds for public housing authorities. In addition, a hospital lobby group has estimated that the President's Medicaid and Medicare proposals would increase costs to the State's hospitals by $1.8 billion annually.

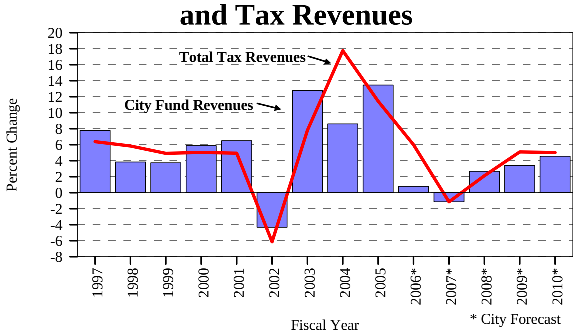
Revenue Trends

FY 2006 is the third consecutive year that the City has experienced substantial unexpected tax revenue increases since it began to emerge from its most recent economic downturn. This surge in the tax revenue base is expected to have recurring effects in subsequent years, boosting collections for fiscal years 2007 through 2009 by about $1.8 billion annually.

Nonetheless, collections do not show sizable year-to-year growth because of a projected softening of the economy. After adjusting for temporary increases in the sales and personal income taxes, growth in total tax revenues are forecast to slow from 12.1 percent in FY 2005 to 7.9 percent in FY 2006 and only 0.2 percent in FY 2007, but then to rise to 2.1 percent in FY 2008 and to 5 percent annually in fiscal years 2009 and 2010.

Graph 2

Annual Change in City Fund Revenues and Tax Revenues

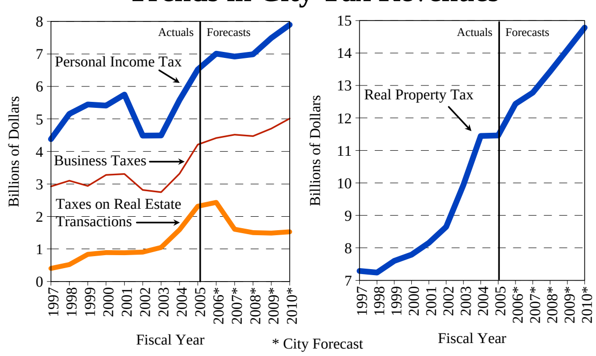


Note: Assumes implementation of the gap-closing program.
Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC Analysis

Overall, City fund revenues[5] are expected to decline by 1.1 percent in FY 2007 (see Graph 2), as the projected slowdown in tax revenue growth is accompanied by a decline in miscellaneous revenues. Growth is projected to rebound in subsequent years with the expected improvement in tax revenues.

Graph 3

Trends in City Tax Revenues



Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC Analysis

5 Our estimates of City fund revenues include the portion of personal income tax revenues dedicated to pay debt service on bonds issued by the Transitional Finance Authority, and revenues dedicated to pay debt service on tobacco bonds.

While the City's economy faces risks, it appears unlikely that tax revenues would fall to the levels of the most recent recession. The expiration of temporary tax increases and the projected slowing in the City's economy is expected to affect tax growth during this period (see Graph 3), but our analysis of the City's revenue forecasts indicates that tax collections could continue to exceed the City's expectations—by $400 million in FY 2006 and by $600 million in FY 2007.

Major revenue trends include the following.

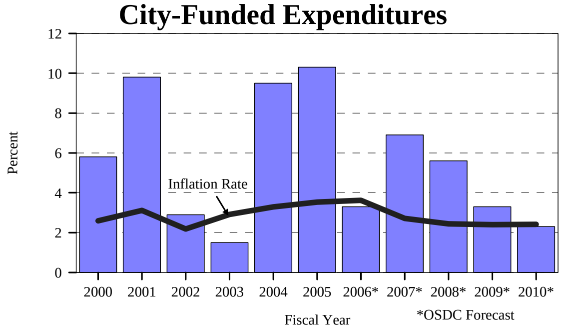
- Personal income tax collections are projected to decline by 1.3 percent in FY 2007, but then to grow at a higher rate in each of fiscal years 2008 and 2009. Economic conditions are expected to soften during calendar year 2007, resulting in a slowdown in the growth of both employment and wages. The City also expects a decline in capital gains realizations, which have surged in FY 2006. Additionally, the expiration of the temporary high-income surcharge will reduce FY 2007 collections by $395 million.
- Business tax revenues, which have been demonstrating strong growth in FY 2006, are projected to slow somewhat in FY 2007 in response to expected slowdowns in the City's economy and the growth of national corporate profits. Weak corporate profits are also forecast to continue through FY 2008, and business tax revenues are projected to decline before increasing in fiscal years 2009 and 2010.
- Real estate transaction tax collections are expected to decline in FY 2007 by 34 percent after setting a new record of $2.4 billion in FY 2006. Although collections are likely to slow down next year, we believe the reduction will be more modest and will occur over a longer period of time than the City forecasts. The market for commercial properties remains robust, but the City projects that single-family home values will decline by about 10 percent through FY 2009. A recent study by the National Association of Realtors, however, suggests that price declines in the New York metropolitan region are unlikely given continued employment gains.

- Real property tax collections—the City's single-largest source of tax revenue—are projected to increase by $346 million next year and by a total of $2.6 billion by FY 2010. The gain would have been even greater except that assessments for rental properties, which are based on the net income associated with operating the properties, were held down by rising costs for insurance and fuel. Since assessment changes for most of these properties are phased in over five years, the full impact of these rising costs is not yet fully reflected in assessments. Also, a pipeline of prior assessed value increases not yet phased in will help the City maintain revenue growth in fiscal years 2008 through 2010.

Expenditure Trends

City-funded expenditures—after adjusting for surplus transfers that can mask expenditure trends and after taking into account Transitional Finance Authority (TFA) and TSASC debt service—are projected to increase by 6.2 percent in FY 2006. This estimate, however, includes a planned $1 billion discretionary transfer to the City's proposed health insurance trust fund for retirees. Excluding this transfer, City-funded spending would increase by only 3.3 percent (see Graph 4).

Graph 4
Annual Change in City-Funded Expenditures

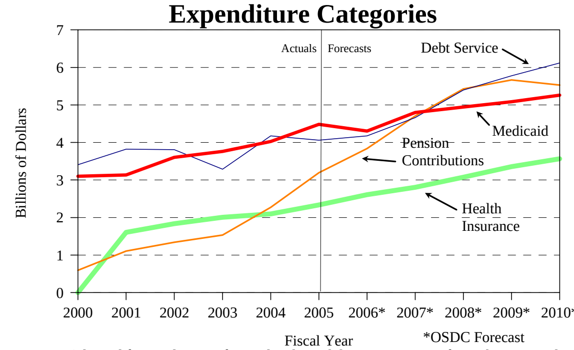


Note: Adjusted for surplus transfers and a planned discretionary transfer to the proposed health insurance trust fund for retirees..
Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC Analysis

Even though pension contributions and health insurance costs will continue their rapid growth in FY 2006, the budgetary impact should be mitigated by extraordinary Medicaid savings, a decline in public assistance spending, and relatively slow growth in wages.

Excluding the $1 billion contribution to the proposed retiree health insurance trust fund in FY 2007, spending would increase by 6.9 percent or $2.5 billion.[6] Of this amount, debt service, Medicaid, pension contributions, and health insurance account for more than $2 billion (see Graph 5). Throughout the balance of the financial plan period, expenditures are projected to grow at an average annual rate of 3.7 percent. These estimates, however, assume that future wage increases are limited to 1.25 percent annually after FY 2006.

Graph 5
Trends in Selected City-Funded Expenditure Categories



Note: Adjusted for surplus transfers and a planned discretionary transfer to the proposed health insurance trust fund for retirees.
Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC Analysis

The City-funded workforce has been growing steadily over the past few years and is projected to reach 257,100 by June 2007. In FY 2006 the City plans to add 2,296 employees, with most of the increase targeted at health and social services agencies, such as the Administration for Children's Services. Through December 31, 2005, however, the City had only added 217 employees and these hiring delays are likely to result in savings of $50 million in FY 2006.

Major expenditure trends include the following.

- Debt service costs are projected to total nearly $4.7 billion in FY 2007, an increase of $485 million or 11.6 percent over the level projected for FY 2006. By FY 2010, these costs are expected to reach $6.1 billion—an average annual growth rate of 10 percent or four times the projected local rate of inflation. The debt service burden is projected to rise from 11.2 percent in FY 2006 to 12.6 percent in FY 2007; then rise to 15.1 percent in FY 2009, which will be the highest level in the past 15 years (see Graph 6); and after that to

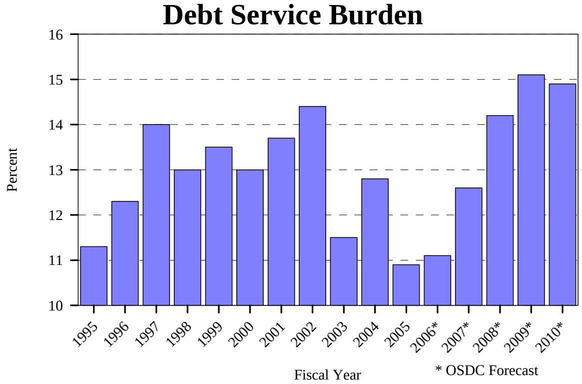
[6] Including the contribution, City-funded spending would rise by 6.8 percent in FY 2007.

remain relatively stable at 14.9 percent in FY 2010.[7]

The City could realize debt service savings of $102 million during fiscal years 2006 and 2007 because interest costs could be lower than projected as a result of likely delays in issuing Hudson Yards Infrastructure Corporation bonds.

Graph 6

Debt Service Burden



Sources: NYC Comptroller; NYC Office of Management and Budget; OSDC Analysis

- Pension contributions are projected to increase from $3.8 billion in FY 2006 to $4.7 billion in FY 2007, and then reach $5.5 billion by FY 2010. These estimates reflect changes in actuarial methods and assumptions recently proposed by the City Actuary and adopted by the trustees of the retirement systems. These changes include a one-year lag in calculating contributions, as was recently adopted by the State; the extension of the phase-in period for investment gains and losses, from five to six years; full funding of retiree cost-of-living adjustments; and other changes in demographic assumptions. The one-year lag and the cost-of-living adjustment require State approval, which the City expects to obtain.

  These changes will permit the City to defer $1.5 billion in planned contributions for fiscal years 2006 and 2007 to subsequent years. The City will realize savings of $925 million in FY 2006 and $571 million in FY 2007, but contributions will rise by $161 million in FY 2008, $452 million in FY 2009, and $211 million in FY 2010.

- Medicaid is projected to grow during the financial plan period much more slowly than was projected two years ago, as actions taken by the State will ease the burden on localities. State initiatives include a takeover of the local costs of Family Health Plus; the enactment of various cost-containment measures; and the imposition of a cap limiting growth in the local share of Medicaid expenditures to about 3 percent annually after FY 2007.

  These actions will reduce the City's costs by $5 billion through 2010. Medicaid costs are now projected to grow from $4.3 billion in FY 2006 to $5.3 billion by FY 2010, an increase of 23 percent, in part because of one-time savings in FY 2006 associated with implementation of the State cap.

- Health insurance costs for municipal employees are projected to grow from $2.6 billion in FY 2006 to $3.6 billion in FY 2010, an average annual rate of 8.1 percent, reflecting the financial plan assumption that health insurance premiums will continue to grow much faster than the local inflation rate. In addition, the City intends to contribute $1 billion in each of fiscal years 2006 and 2007 to a retiree health benefits trust to help fund future liabilities.

- Energy costs, which include electricity, natural gas, steam, heating fuel, and gasoline, averaged $453 million during fiscal years 2003 through 2005. These costs are projected to reach $647 million in FY 2006 and $660 million in FY 2007, and then to decline in subsequent years.

- Judgments and claims are projected to reach $601 million in FY 2006, and then to grow to $793 million by FY 2010. In connection with the attack on the World Trade Center (WTC), the last remaining property damage claim against the City—which was made by Consolidated Edison (ConEd) and its insurers—was dismissed on January 12, 2006. Whether ConEd will appeal is not yet known. The City continues to seek a limitation of its liability in the Staten Island ferry case, to $14.4 million (the value of the ferry), under federal maritime law. A decision, which would be subject to appeal, is anticipated before the end of June 2006.

[7] The debt service burden is defined as City-funded debt as a percent of City fund revenues, including amounts to support TFA and TSASC debt service.

- Overtime costs in the uniformed agencies are projected to total $615 million in FY 2006 and then decline to $487 million in FY 2007. While overtime costs in the Police Department could exceed the City's estimates by $70 million in FY 2006 and by about $150 million in subsequent years, these costs could be offset by reserves, attrition, and federal grants. Overtime costs, however, are likely to exceed planned amounts in the Fire and Correction Departments by $50 million in FY 2007 and $40 million annually in subsequent years.

Other Issues

The following issues could significantly affect the City during the financial plan period.

Collective Bargaining

After protracted delays and sometimes contentious negotiations, the City reached new labor agreements with most of the municipal workforce for the 2002 to 2006 round of bargaining. While the agreements provide for substantial wage increases, the City obtained significant productivity improvements and other savings to help fund the wage increases.

The February Plan funds wage increases for all employees through FY 2006 at terms similar to those reached with the City's sanitation workers. While the outcome of negotiations may result in somewhat higher or lower costs, the impact on the financial plan will likely be minimal.

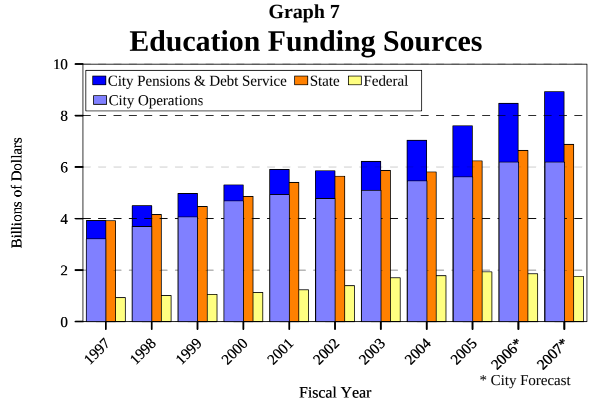
A significant portion of the productivity savings in the recently completed round of negotiations is expected to come from reductions in starting salaries and slower salary progressions. Since implementing these reductions, however, the Police Department has had difficulty recruiting candidates. Thus, future agreements could call for an increase in starting salaries, which would erode some of the anticipated savings.

The February Plan assumes that future wage increases for all employees will average 1.25 percent annually from FY 2007 through FY 2010. Wage increases at the projected inflation rate, however, would increase costs by $100 million in FY 2007, $350 million in FY 2008, $650 million in FY 2009, and $950 million in FY 2010. The Mayor has announced that in the next round of negotiations he intends to seek a reduction in pension and health insurance costs similar to the changes proposed during negotiations between the Metropolitan Transportation Authority and the Transport Workers Union.

Education

The February Plan allocates $14.9 billion to the Department of Education for operations in FY 2007, an increase of $148 million over the FY 2006 level. Of that amount, the City would fund 42 percent; the State would fund 46 percent; and the federal government, private grants, and miscellaneous fees would fund the remainder. After taking into account mandatory funding for pension contributions and debt service ($2.7 billion), which are funded elsewhere in the City's budget, the City's contribution rises to 51 percent and the State's contribution falls to 39 percent (see Graph 7).

Graph 7



Note: Analysis includes debt service and pensions.
Sources: NYC Office of Management and Budget; OSDC Analysis

State and City education contributions will be debated as the State attempts to resolve a lawsuit over its system of education finance, *Campaign for Fiscal Equity v. State of New York*. In October 2005, the Governor appealed a court order that the State provide City schools with $5.6 billion in operating aid over four years and $9.2 billion in capital budget funding over five years. The Appellate Division's decision is expected between March and June 2006. If the decision is not in favor of the plaintiffs, the Campaign for Fiscal Equity is expected to appeal to the Court of Appeals, the State's highest court.

The Governor, the Assembly Speaker, and the Senate Majority Leader have suggested that the City should fund part of any settlement. If the City were required to contribute the share of additional assistance recommended by the Governor (40 percent), it would need to increase contributions by as much as $560 million in FY 2007, $1.1 billion in FY 2008, $1.6 billion in FY 2009, and $2.2 billion in FY 2010.

In June and September 2005, the federal government released audits of the Department of Education's Medicaid claims for transportation and speech therapy services. Auditors found $531 million in questionable federal reimbursements, of which the City could be responsible for half. Findings from a third federal audit are pending, which could lead to higher City-funded expenditures.

The Schools Chancellor has announced that the department will reduce administrative costs by $200 million over the next four years. The department has hired a consultant to identify potential savings, efficiencies, and additional revenues. Although the Chancellor has stated that these resources will be redirected to the City's schools, the February Plan does not reflect the Chancellor's intention.

Off-Track Betting Corporation

The Off-Track Betting Corporation (OTB) provides legalized pari-mutuel wagering that generates revenue for the City, the State, and the horse racing and breeding industries. The OTB typically provides New York City with revenues from a 5 percent surcharge on winning wagers, as well as residual revenues, which are any funds left over after the payment of all operating expenses and all statutorily mandated distributions to the racing industry, the State, and other localities.

Surcharge revenues distributed to the City have stagnated at about $17 million annually since FY 1996, and the OTB has not provided any residual revenues to the City since FY 2004. The OTB projects that it will incur negative residual revenues of $13.1 million in FY 2006, rising to $27.2 million by FY 2010.

Although the OTB's short-term cash outlook has improved since our last review, it still faces long-term challenges. The City has suggested a number of actions that the State could take to improve the OTB's finances, such as changes to the system that distributes OTB revenue to governmental entities and the racing industry, so that the OTB is not required to distribute more than its total net revenue after operating expenses. Other State actions suggested by the City include reducing State-assessed regulatory fees, eliminating subsidies to the harness industry, and increasing the OTB's share of the dollars that are wagered.

Health and Hospitals Corporation

The Health and Hospitals Corporation (HHC) projects a year-end cash balance of $357 million for FY 2006, but also estimates that this balance could be nearly depleted over the next four years. The HHC assumes that the federal and State governments will approve a number of pending actions that would generate just under $400 million in benefits. The HHC may not receive all of the expected approvals, however, and the State and federal governments are considering reforms that could adversely affect HHC finances.

Housing Authority

The New York City Housing Authority (NYCHA), which operates on a calendar-year basis, projects a cash deficit of $190 million in 2006 and slightly smaller amounts in subsequent years. Although the February Plan assumes that the NYCHA will balance its budget in 2006, the NYCHA has not yet developed a plan to do so, and the City could be called upon to increase its subsidy as part of a gap-closing plan.

Officials at the NYCHA attribute the budget gaps to rapidly rising costs of utilities and employee benefits, and inadequate subsidies from the federal, State, and City governments. State and City assistance covers less than 2 percent of operating expenses, and NYCHA relies heavily on federal support of its operations. Federal funding formulas were recently revised in such a way that the age of NYCHA properties is not fully factored into federal funding levels. Also, the President's executive budget proposal would reduce federal support for public housing authorities in New York State. Moreover, the authority has not revised its rent schedule since 1989.

Hudson Yards Infrastructure Corporation

The Hudson Yards Infrastructure Corporation (HYIC) plans to issue $3 billion in bonds to finance the extension of the No. 7 subway line and other infrastructure to spur economic development on the far West Side of Manhattan. The planned development, however, is not expected to generate sufficient revenues to cover the interest costs until at least 2015. The City will pay, subject to an annual appropriation, the interest on HYIC bonds to the extent that project revenues are insufficient to cover these costs. While the City estimates the interest costs at nearly $1 billion through 2015, there is no limit on the City's liability.

The City also plans to use the Transitional Finance Authority (TFA) as a credit enhancement for a portion of the HYIC bonds. In the event that project revenues are insufficient to meet debt service obligations, the TFA would purchase up to $750 million in HYIC bonds. Such a move could adversely affect the City's budget and credit rating. As discussed in our previous reports, the State Comptroller does not believe the TFA is authorized under State law to purchase HYIC bonds; the City, however, contends that such purchases would be allowable.

According to City officials, the first planned bond sale has been delayed until the beginning of FY 2007 because specific details regarding tax incentives to be offered to developers on the far West Side, as well as anticipated revenue streams from these developments, have not yet been finalized. The City expects to have the final details of the incentives completed by the spring, in time for the rating agencies to review the project before a summer debt issuance. The timing of this may cut short a public debate on the tax incentives and other elements of the project.

Lower Manhattan Redevelopment

Redevelopment plans for the World Trade Center (WTC) site, which are overseen by the Lower Manhattan Development Corporation (LMDC), have experienced significant delays. Recent events could lead to additional setbacks. The City has called on the LMDC to revise redevelopment plans to provide for greater retail and residential development and less office space and for the involvement of additional developers.

Governor Pataki agreed to award $1.67 billion in State-controlled Liberty Bonds to the WTC site developer contingent on the developer and the Port Authority, which owns the site, reaching an agreement on a number of issues by March 14. The City has not yet allocated its remaining allotment of Liberty Bonds, and has indicated it may not allocate them to the developer, which could further delay development at the site.

Javits Convention Center Expansion

In 2004, the State approved legislation authorizing the Convention Center Development Corporation (CCDC), a subsidiary of the Empire State Development Corporation, to issue bonds to renovate and expand the existing Jacob K. Javits Convention Center.

In January 2006, the CCDC released a revised project plan that reduced the amount of new exhibition and meeting space by more than 20 percent compared to the original plans. At the same time, the projected cost of the expansion has increased from $1.4 billion to an estimated $1.7 billion. Some supporters of the convention center expansion have expressed concerns that the new plans may not meet the goals presented to the State Legislature when it approved the expansion.

The CCDC intends to finance the project with $645 million in bond proceeds, $700 million from the City and State, and $339 million from the sale of property owned by the CCDC just south of the existing Javits Center—though some supporters have suggested that the estimate of proceeds from the sale of the property is overly optimistic. The State intends to fund its $350 million commitment through a restructuring of existing CCDC bonds currently scheduled to be retired in 2011. The City included funding for its portion of the expansion in its 2006-2010 Capital Plan.

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